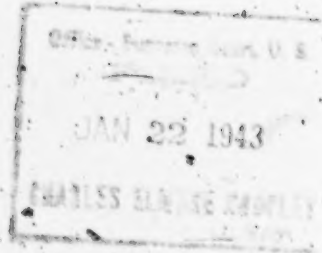


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No. 319

In the Supreme Court of the United States

OCTOBER TERM, 1942.

FIDELITY ASSURANCE ASSOCIATION AND CENTRAL
TRUST COMPANY, PETITIONERS

v.

EDGAR B. SIMS ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE
COMMISSION

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission became a party in the District Court to the present proceeding for the reorganization of Fidelity Assurance Association under Chapter X of the Bankruptcy Act,¹ participated as an appellee before the Circuit Court of Appeals, and is named a respondent here. On the points which the court below

¹ The Commission appeared at the court's request pursuant to the provisions of Section 208 of the Bankruptcy Act, as amended by Section 1 of the Act of June 22, 1938, 52 Stat. 894 (11 U. S. C., § 608).

found to be dispositive, the Commission's position here is, in general, aligned with that of petitioners.

This brief is confined to the two issues decided by the court below—whether the debtor is an insurance company and whether its petition under Chapter X was filed in good faith. Respondents in their several briefs in opposition have indicated an intention to urge here a number of other matters collateral to these main issues. Some of these issues (W. Va. Br. in Opp., Addendum, pp. 53-57) raise no substantial questions and were not passed upon by the court below; we shall therefore not treat them in our main brief. Other issues, such as those relating to the legality of the Debtor's meetings and elections (W. Va. Br. in Opp., pp. 20-21; 41-45), largely arise from a conflict among private interests formerly connected with the management involving efforts to control the administration of the company's affairs.² Except to the

² The Commission did not argue below the questions whether there was valid corporate action authorizing or ratifying the filing of the petition. The Commission did argue below that valid corporate action ratifying the filing of the petition would validate the petition. *Watts v. Liberty Royalties Corp.*, 106 F. (2d) 941 (C. C. A. 10); *Massachusetts Construction Co. v. Kidd*, 142 Fed. 285 (C. C. Mass., 1905); *Couch v. Central Bank and Trust Corp.*, 297 Fed. 216 (C. C. A. 5); *Laurence v. Montgomery Gas Company*, 88 W. Va. 352, 106 S. E. 890 (1921); *Limer v. Traders Co.*, 44 W. Va. 175, 28 S. E. 730 (1897); *Porter v. Lassen County Land and Cattle Co.*, 127 Cal. 261, 59 Pac. 563 (1899); *Calumet Paper Co. v. Haskell Show Printing Co.*, 144 Mo. 331, 45 S. W. 1115 (1898); *Restatement of Agency*, Sections 84, 100.

extent that they may indicate the necessity for Chapter X proceedings, we think it inappropriate for us to argue these questions of internal corporate management.*

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 238-263) is reported in 129 F. (2d) 442. The opinion of the District Court (R. 176-202) is reported in 42 F. Supp. 973.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 16, 1942 (R. 263-264). A petition for rehearing (R. 264-266) was denied July 22, 1942 (R. 267). A petition for a writ of certiorari was filed August 20, 1942 and granted October 12, 1942. Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether petitioner association was an "insurance corporation" within the meaning of Section 4 of the Bankruptcy Act when it filed a petition for reorganization as a corporate debtor.

* Those issues do not involve issues of good faith within the meaning of Section 146; in so far as they may be thought to reflect on the debtor's motives in filing a petition under Chapter X, they are immaterial to the statutory tests of Section 146. Cf. *Marine Harbor Properties, Inc. v. Manufacturer's Trust Co.*, No. 24, this Term, decided November 9, 1942.

2. Whether the petition was filed in good faith within the meaning of Section 146 (3) and (4) of the Bankruptcy Act.

STATUTES INVOLVED

Section 4 (a) of the Bankruptcy Act, as amended (11 U. S. C. § 22 (a)) provides:

Any person, except a municipal, railroad, insurance, or banking corporation or a building and loan association, shall be entitled to the benefits of this Act as a voluntary bankrupt.

Section 141 of the Bankruptcy Act, as amended (11 U. S. C. § 541) provides:

Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied.

Section 146 of the Bankruptcy Act, as amended (11 U. S. C. § 546), provides, in part:

Without limiting the generality of the meaning of the term "good faith", a petition shall be deemed not to be filed in good faith if—

(3) it is unreasonable to expect that a plan of reorganization can be effected; or

(4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding.

The relevant state statutes governing deposit requirements and receivership or liquidation proceedings are set out in Appendix D, Appendices, pp. 10-74.

STATEMENT

The facts as found by the District Court in its opinion and as shown by the evidence may be summarized as follows (other facts bearing on the issues whether petitioner is an insurance company and the relative advantages of state and Chapter X proceedings are set out in the Argument, *infra*):

1. *The Debtor's Business, History, and Financial Condition.*

Fidelity Assurance Association, the petitioner, is a West Virginia corporation with its principal place of business in Wheeling, West Virginia (R. 4, 612). From November 1912 to the end of 1940, under the name Fidelity Investment Association, it was engaged exclusively in the business of selling its own securities in the form of investment contracts (called "annuity contracts" under the West Virginia statute, and recently known as face-amount certificates) and in investing and re-investing the proceeds of such sales (R. 177-178, 240).

At various times, Fidelity sold six different series of contracts in 29 states and the District of Columbia (R. 304-316, 479).

There are outstanding contracts in the face amount of \$181,948,026.70, representing a net cash

liability of \$23,475,668.67 owed to approximately 88,000 holders (R. 242; Ex. 48). Holders of such contracts now reside in each of the 48 states, the District of Columbia, and foreign countries (R. 242; Ex. 48).

The several series of contracts differ only in detail. In general each series provides that the contract holder is to pay a fixed sum monthly for a named period, *e. g.*, ten years, in return for which Fidelity is obligated to pay a fixed sum on a named date (three to thirteen months after the contract holder's last payment), or at the option of the contract holder, to pay the principal sum in ten annual installments (R. 178; Ex. 1-5). Each series of contracts embodies loan and cash surrender provisions under which monthly payments must be made by the purchaser for a period of at least nine months before the contract has any cash surrender value and, depending upon the contract series, for a period of six and a half to nine years before that value is as much as the amount paid in, without interest (R. 178; Ex. 1-5). The monthly payments, after fees and charges are deducted, are required by the contracts to be set aside in reserve funds, which the later contracts required to be segregated by contract series, to assure that Fidelity will be able to discharge its liabilities under the contracts at maturity (Ex. 4, 5).⁴

⁴ The terms of the contracts and the manner in which the company conducted its business are described in detail in the Report of the Securities and Exchange Commission on Com-

In addition, the Series B contract which Fidelity sold from 1935 to 1940 permits the contract holder to avail himself of a blanket insurance policy issued by Lincoln National Life Insurance Co., an Indiana corporation which has no connection with Fidelity (R. 416, 783; Ex. 4). The premium for this insurance is deducted by Fidelity from the contract holder's periodic payments and is remitted by Fidelity to the insurance company (R. 783-784). If an insured contract holder dies before completing his payments, the insurance company pays Fidelity the discounted value of the remaining payments so that the certificate will mature as originally issued (R. 681-682; 783-784). At least until the 1941 events described below (pp. 12-13), Fidelity assumed no insurance liability under this form of contract or otherwise (Ex. 4; R. 377-378).

In accordance with its undertaking, embodied in its contracts, to segregate the assets by contract series, Fidelity kept books which show the status of the several series separately, and which further show the particular securities allocated to the various funds reserved for the respective contract series (R. 180, 331-332; 342-344; 367-368, 379-381, 581; Ex. 25). In keeping with this theory of segregation, securities were "sold" and moneys

panies Issuing Face Amount Installment Certificates, submitted to Congress March 13, 1940, pursuant to Section 30 of the Public Utility Holding Company Act of 1935 (H. Doc. 659, 76th Cong.). See especially pages 200-204, 222-224. This report is in evidence in this proceeding (Ex. 6, 12) and copies have been filed with the Clerk of this Court.

were "borrowed" on open book account between the separate series funds (R. 333, 409, 658-660). Since securities were carried on the company's books at cost, interfund "sales" above cost increased the book value of the company's portfolio and created paper profits which the stockholders shared with the contract holders (R. 658). Interfund "loans" made the total corporate cash freely available in making payments to contract holders of any series, so that the corporation could avoid liquidation of that series' securities, resultant realization of losses, reduction in the book value of the portfolio, and decrease or elimination of income available for stockholders (R. 381-382). The funds which have interfund accounts payable appear to be insolvent, and the solvency of other funds depends on the extent to which their interfund accounts receivable are collectible assets (R. 492-493; Ex. 26, 82).

The domiciliary State of West Virginia required Fidelity to deposit as security for its obligations to all contract holders, wherever located, property of a value equal to \$100,000 more than the company's net cash liability on all its outstanding contracts, less the amount of similar deposits required by other states. West Virginia Code, c. 33, art. 9, sec. 3, (Appendix D, Appendices, pp. 63-65). Of the 28 states other than West Virginia in which the company sold its contracts, only 14 required a deposit, the nature and amount of which varied from

state to state.⁵ The property thus deposited by Fidelity constitutes about 95 percent of its assets (R. 242; Ex. 25).

Beginning with the Series B and D contracts in 1934, when Fidelity deposited property in the states which required such deposits, it made efforts to maintain segregation by series (R. 601-612, 644, 660; Ex. 60, 61, 72, 73). But some of the state depositaries refused to segregate the securities deposited with them with respect to the particular funds of Fidelity to which the securities belonged (R. 592-593, 633-636; Ex. 60, 62). The state depositaries were aware that Fidelity was contractually obligated to segregate the Series B and D funds, and that in many instances they were holding securities to secure contractual liabilities relating to series other than those to which the securities belonged (R. 654-655, 609, 628, 760-761, 768; Ex. 72-79).

Appendix A, Appendices, pp. 1-2, shows the market value of securities deposited in the various states segregated by series as compared with the net cash surrender liabilities in those states broken down by series.⁶

⁵ The states which required deposits are Alabama, Delaware, Illinois, Iowa, Indiana, Kansas, Kentucky, Maryland, Missouri, Ohio, Pennsylvania, Tennessee, Virginia, and Wisconsin (R. 241, 347-373). Their statutory requirements relating to deposits are set out in Appendix D, Appendices, pp. 10-74.

⁶ Appendix A was compiled from the Chapter X trustee's report filed pursuant to Section 167 of the Bankruptcy Act, filed October 10, 1941 (not printed).

2. Events Which Led to the Filing of the Petition Under Chapter X.

Except for a brief period in 1937, Fidelity has been insolvent continuously at least since 1933 (R. 440-443). Its assets have been dissipated by advances to salesmen, margin trading in speculative securities, disastrous investments, and extravagant non-income-producing expenditures (R. 440-476). A suit by the Securities and Exchange Commission in 1938 to enjoin violation of the fraud provisions of the Securities Act of 1933,⁷ and a stockholder's suit in 1939 for a receiver and other relief,⁸ also marked Fidelity's recent history and had an important impact on its business.

Fidelity made efforts to solve its financial difficulties by reorganization and procurement of new capital almost continuously from 1932 (R. 1136-43).⁹ The enactment of the Investment Com-

⁷ For the complaint, affidavits, and decree in this case see Report, *supra*, note 4, at 197-245, 257-258.

⁸ See *McCammon v. Fidelity Investment Assn.*, 26 F. Supp. 117 (N. D. W. Va.), affirmed, *Hutchinson v. Fidelity Investment Assn.*, 106 F. (2d) 431 (C. C. A. 4).

⁹ From 1936 "on back to the early thirties" the directors, the executive committee, and the finance committee did "talk about trying to get new capital and how we might recapitalize and whatnot" (R. 1136). From 1938 through 1940 (R. 1136-7) Arthur Koontz, a director and member of the finance committee (R. 1167) personally endeavored to reorganize, or procure new capital for, the company from investment banking and commercial banking sources, insurance companies, investment trusts, and finance companies (R. 1136-43). Finally, in 1940, Allen G. Messick and Ber-

pany Act on August 22, 1940, 54 Stat. 789 (15 U. S. C. § 80a (1)-(52)), however, seriously complicated these reorganization efforts. Fidelity was subject to the Act, which, as a condition precedent to the sale of new contracts, required the maintenance of specified reserves and imposed expense loading limitations (Sec. 28). Fidelity's financial condition precluded its satisfying these reserve requirements and its scale of expenses exceeded the income it could expect under the expense loading limitations (R. 404, 630, 669, 796-797, 864-877). But if it could not sell new contracts, it could

ward Rosset, of Chicago, entered into a contract to invest \$500,000 in a new company which would assume certain of Fidelity's contract liabilities (R. 1142-4). This contract was never performed and Koontz's efforts to secure new capital for the company ceased when Messick became chairman of the board in 1940. Messick continued the efforts to secure new capital. (R. 1144.)

In December 1940, Koontz resumed his efforts to reorganize the company (R. 1144-5). He did some work "with a view of preparing the company to go into the business of life insurance if the [company's financial] statement, in the Auditor's judgment, showed that it should be permitted to write life insurance" (R. 1146, 1157) "but they were never able to get the green light from the Commissioner" (R. 1146). During this period the company "was not doing business—it was not permitted to do business, and Mr. Sims [Auditor and *ex officio* Insurance Commissioner of West Virginia, see *infra*, p. 12] had stated to them that he wasn't going to permit them to do business unless there was a change in the situation" (R. 1156). Thus, the beginning of 1941 was characterized by continuous efforts to work out a voluntary recapitalization plan (R. 1147-9) to forestall involuntary proceedings (R. 1150, 1184-6).

become a liquidating enterprise. Consequently, in an attempt to gain time to devise a permanent solution for Fidelity's difficulties, its board of directors adopted the expedient of amending its charter on December 31, 1940, to change its name to "Fidelity Assurance Association" and to enlarge its objects and purposes by the addition of life insurance powers (R. 541; Ex. 20). Fidelity did not, however, abandon its existing charter power to continue the annuity contract business in which theretofore it had been exclusively engaged. Instead, in order to be able to continue receiving payments on contracts previously sold and to make payments on contracts which matured or were surrendered for cash (R. 669), Fidelity filed with the Securities and Exchange Commission the notification of registration as an investment company required by Section 8a of the Investment Company Act (R. 667).¹⁰

After Fidelity amended its charter, the respondent Edgar B. Sims, Auditor and *ex officio* Insurance Commissioner of West Virginia, issued a license to Fidelity to do business as an insurance company from January 1, 1941, to March 31, 1941, upon the express condition that it would engage in no business except the servicing of its outstanding face amount certificates until he gave it permission to do so (R. 406, 438, 701; Ex. 24). In

¹⁰ No other form of registration with the Commission has yet been required of face amount certificate companies.

spite of this condition, Fidelity transmitted to its Series B contract holders riders which when signed by them purported to make Fidelity an insurer (R. 237-238; Appendix B). Upon expiration of its insurance license on March 31, 1941, Fidelity applied for a renewal which was executed but never delivered (R. 237).¹¹ On April 4, 1941, Sims directed Fidelity to discontinue the transaction of all business (R. 246, 702). On April 11, 1941, the Circuit Court of Kanawha County, West Virginia, appointed receivers for Fidelity on a petition filed by Sims (R. 246; Ex. 21). Shortly thereafter independent actions were begun in eleven other states (R. 246-247). Most of these were liquidation proceedings begun by state officials in the state courts, some were equity proceedings in state or federal courts, and some were purely administrative. The statutory provisions under which these proceedings were instituted in the various states are set out in Appendix D, Appendices, pp. 10-74. None of the state proceedings made substantial progress toward the collection of assets and determination of claims, except in Wisconsin where approximately half of the local de-

¹¹ Fidelity's investment company license also expired on March 31, 1941. On March 8, 1941, the statute providing for such licenses (West Virginia Code, c. 33, art. 9, sec. 1) was repealed and replaced by a statute which is integrated with the Investment Company Act of 1940 (W. Va. L. 1941, c. 46, March 8, 1941). Fidelity never qualified under the new West Virginia statute.

posit was liquidated and proofs of claim were received.¹²

3. *The Chapter X Proceeding.*

On June 6, 1941, Fidelity filed a voluntary petition under Chapter X of the Bankruptcy Act in the District Court of the United States for the Southern District of West Virginia (R. 4). The court appointed a trustee, enjoined the various local receivers and others from disposing of Fidelity's property in their hands, and ordered the local receivers to deliver to the trustee the Fidelity property which they held (R. 1). The court later ordered state officials holding deposits of Fidelity's property to deliver them to the trustee (R. 11). The local receivers and depositaries and various creditors were permitted by the court to intervene and file answers controverting the allegations of Fidelity's petition (R. 15-20, 29, 31, 48, 58, 79, 88-96, 118-161). Extended hearings were held on the question of approval of the petition. In the course of these hearings, the district court rescinded its order on state depositaries to turn the deposits over to the trustee, but left the turn-over order in effect as to the local receivers (R. 102-114).

On January 5, 1942, the District Court approved the petition and overruled motions to rescind its standing turn-over and freezing orders (R. 175).

¹² After the decision of the court below certain of the states called for the filing of proofs of claim, pursuant to that court's order on the stay of its mandate (R. 268-270).

The Circuit Court of Appeals reversed (R. 263) on two separate grounds: (1) that Fidelity was an insurance corporation and therefore not eligible for reorganization under Chapter X of the Bankruptcy Act; and (2) that the petition had not been filed in good faith, since rehabilitation of Fidelity was not reasonably possible and therefore continuation of the prior pending proceedings for liquidation purposes would better serve the interest of creditors than proceedings under Chapter X (R. 238-263).¹³

SPECIFICATION OF ERRORS

The court below erred:

1. In holding that petitioner Fidelity Assurance Association is an "insurance corporation" within the meaning of Section 4 of the Bankruptcy Act, and so is ineligible to receive the benefits of the Act as a voluntary bankrupt.

2. In holding that the petition was not filed in good faith.

SUMMARY OF ARGUMENT

I

Since the facts establish that Fidelity is not an insurance corporation, it is not disqualified under Section 4 (a) of the Bankruptcy Act from the benefits of that Act as a voluntary bankrupt. For 28

¹³ The court below did not pass upon the other objections to the Chapter X proceedings raised by respondents and others.

years and until December 1940, Fidelity was licensed only to sell annuity contracts under a provision expressly inapplicable to insurance corporations; it was, therefore, not authorized to do an insurance business and it did not engage in such business.

The amendment of its charter in December 1940 to include insurance powers, and its issuance of riders purporting to assume liability under the insurance provisions of its Series B contracts, were insufficient to make Fidelity ineligible under Section 4 (a). All of the \$23,000,000 liabilities of Fidelity were incurred in its sale of investment contracts prior to its charter amendment. The enlarged license to do insurance business was merely an artificial device to achieve other purposes and it was expressly ineffective. Nor, in fact, did the issuance of the riders result in any insurance liability since the actual consequence was only the continuance of an arrangement under which an insurance company unconnected with Fidelity insured the contract payments on a group basis.

Even if the issuance of riders may be considered to be the doing of insurance business contrary to its actual licensed powers, the controlling test is the nature of the principal pursuit of the company; the touchstone is what the company actually does, not what it is empowered to do. Plainly here Fidelity's insurance business, if any, was of negligible significance for purposes of determining its eligibility under Section 4 (a).

A. Whether Fidelity can be reorganized on a going concern basis or whether only some form of liquidation is in order for it, there is no lack of good faith within the meaning of Section 146 (4). That the interests of the creditors will not be subserved better by the various state receivership and liquidation proceedings than in a Chapter X proceeding appears from three separate factors establishing the desirability of a central administration which provides a machinery for effective marshalling of assets and equitable and precise distribution to creditors who are legally entitled to such assets.

1. The facts relating to Fidelity's course of business and its reorganization efforts show that there is a necessity for the impartial and expert investigation which Chapter X affords. The record indicates that extravagance and mismanagement mark Fidelity's business. Fidelity and its officers and directors have been enjoined from violations of the fraud provisions of the Securities Act. Whatever the actual facts may ultimately be disclosed to be, investigation of possible civil actions on behalf of Fidelity's estate is appropriate. Yet the state proceedings give no promise of vigorous investigation comparable to that which may fairly be expected in Chapter X proceedings. Thus, in states other than West Virginia, there are obstacles of venue and jurisdiction, while in respect of the West Virginia proceedings, the record establishes interlock-

ing relationships among the receivers, their counsel, and Fidelity's officials, which would at the least indicate divided loyalties standing in the way of thorough exploration of the facts.

2. The task of marshalling assets and of distribution presents a number of difficult issues which can best be settled in a single administration under Chapter X, rather than by separate administration in a dozen state proceedings. In order to assure that there be distribution of the assets in the proper amounts to legally entitled creditors, the assets of the various series of contracts must be disentangled, and distribution must depend upon the determination of complex issues presenting questions both of identity of the creditors and of amount due. The state officials, however, propose immediate distribution without awaiting litigation of such issues. Unless there is a single forum which is available for the presentation of all these issues, the contract holders will be likely, as a practical matter, to be deprived altogether of the opportunity to litigate their claims, for there are many classes of contract holders scattered throughout the country, with claims on the basis of net cash liability, averaging only \$273.

3. A single administration under Chapter X furnishes a superior vehicle for liquidation of Fidelity's assets. Fidelity's portfolio is such as to require skillful and orderly disposition for fullest realization upon the securities. The several state

proceedings are not such as to afford appropriate machinery for such a task.

B. There is no lack of good faith within the meaning of Section 146 (3). Even assuming that Fidelity could not be rehabilitated as a going concern, there are other methods of disposition of the assets which appear to be appropriate here and which satisfy the requirement of Section 146 (3) that it be not unreasonable to expect that a "plan of reorganization" can be effected. For example, the creation of a new corporation or other device to liquidate assets (which respondents now insist is the only feasible course) is a "plan of reorganization" under the Act. Accordingly, it cannot be said that it is unreasonable to expect that a plan of reorganization may be effected.

ARGUMENT

I

FIDELITY IS NOT AN INSURANCE CORPORATION AND CAN BE A BANKRUPT

Section 4 (a) of the Bankruptcy Act (*supra*, p. 4) withholds the benefits of that Act from "insurance corporations." We submit that this exclusion is inapplicable here since Fidelity was not an insurance corporation within the meaning of that section.

The facts relating to this issue are undisputed. They establish that Fidelity cannot be regarded as ineligible for the benefits of the Bankruptcy Act.

For 28 years, until December 1940, Fidelity was licensed only for the purpose of selling the "annuity contracts" described at pp. 6-7, *supra* (Ex. 20). It is clear that the sale of these contracts did not constitute doing an insurance business. It sold these contracts pursuant to its license as an investment company under West Virginia Code, c. 33, art. 9, sec. 1, which was expressly inapplicable to insurance companies.¹⁴ Fidelity, therefore, was not authorized to engage in the insurance business during this period; and it did not so engage (R. 377-378, 416).

The events of December 1940 and thereafter did not transform Fidelity into an insurance corporation. Recognizing that it was unable to qualify under the Investment Company Act of 1940¹⁵ for the sale of new investment contracts, and in order to avoid the requirements of that Act, which are

¹⁴ C. 33, art. 9, sec. 1, provided in pertinent part:

No person, association or corporation shall engage in the business of soliciting or receiving deposits or payments on any annuity contract or certificate or annuity bond in fixed and stipulated installments, within this State, without first having obtained from the insurance commissioner a license to do business in this State: *Provided, however*, That this article shall not be construed as applying to * * * insurance companies, foreign or domestic, duly authorized to do business in this State * * *

This section was repealed by W. Va. L. 1941, c. 46, March 8, 1941.

¹⁵ 15 U. S. C., § 80a (1)-(52). The Act became effective on January 1, 1941.

inapplicable to insurance companies (sec. 3 (b) (3)). Fidelity resorted to the device of amending its charter, as of December 31, 1940, so that it would have power "To issue insurance on the lives of persons and every insurance appertaining thereto and connected therewith, and to grant, purchase and dispose of annuities." (R. 541; Ex. 20.) The added power which it thus procured was not of practical significance. It not only retained its power to deal in annuities, but in fact that continued to be the full extent of the exercise of its charter powers. While after December 31, 1940, Fidelity sold no new annuity contracts (being precluded from doing so under the Investment Company Act of 1940), it continued to make payments on contracts which matured or were surrendered for cash and to service outstanding contracts and collect payments thereon (R. 406), and registered with this Commission under the Investment Company Act for these purposes (R. 667). On the other hand, despite the charter amendment, Fidelity at no time was permitted to engage in insurance business, for its license to engage in such business for the period ending March 31, 1941, was granted by the West Virginia Auditor on the express condition that it would engage in no new business of any kind (R. 227, 406, 438, 701). On March 31, 1941, Fidelity's license to do an investment business and its license to do an insurance business expired together, and renewal was refused (R. 246, 237). By April 4,

1941, its corporate functions of all kinds were suspended (R. 702).

It is apparent, therefore, that when the West Virginia receivership and the instant proceedings were instituted, Fidelity was not licensed to engage in any business whatever, and the only substantial business in which it had ever engaged or for which it had ever been effectively licensed was that of selling annuity investment contracts. And, significantly, all of Fidelity's liabilities of over \$23,000,000—the discharge of which is the concern of the Bankruptcy Act—were incurred in doing the business of selling its investment contracts before Fidelity's charter contained any insurance powers.

The conclusion that Fidelity did not function as an insurance company is not affected by the fact that on December 31, 1940, it sent to the holders of its Series B contracts riders which purported to assume liability under the insurance provisions of those contracts (R. 237; see *supra*, p. 13).¹⁶ The Series B contract holders signed and returned 9,802 of these riders to Fidelity. This circumstance, however, is insufficient to warrant treating Fidelity as an insurance company. If this be an insurance transaction,¹⁷ it was in direct violation of

¹⁶ The riders and accompanying letter appear in Appendix B, Appendices, pp. 3-5.

¹⁷ In its dealings with the Virginia Corporation Commission and the Banking Commission of Wisconsin Fidelity specifically stated that it had issued no insurance policies, pointing out that the riders sent to Series B contract holders created no insurance risks (R. 223-226).

Fidelity's agreement with the West Virginia insurance commissioner that it would write no insurance under its insurance charter and license (*supra*, p. 21). But in any event, it is plain that the transaction was lacking in important elements characteristic of the usual insurance business. As the court below recognized (R. 246), Fidelity continued to transmit the contract holders' premium payments to the Lincoln National Life Insurance Company, which had issued the group insurance policy protecting the Series B contract holders (R. 783 ff). In addition, the issuance of these riders resulted in no insurance liability which Fidelity is being called upon to discharge, since Lincoln National is able to respond on the contract. And, it is to be noted, the court below in reviewing Fidelity's liabilities (R. 241-245) did not refer to insurance liabilities at all. Especially as it relates to the instant question, therefore, the issuance of the riders wrought no significant change from the situation which had originally obtained in respect of the insurance features of the Series B contracts, for Fidelity incurred no real risks and Lincoln National continued to be liable on these contracts under the group insurance policy.

We submit that in these circumstances Fidelity's illegal gratuitous assumption of a liability without risk on outstanding insurance cannot be regarded as having put it into the insurance business.¹⁵

¹⁵ Essentially, the change in debtor's charter and subsequent developments were but steps in an attempted extra-

Even assuming that Fidelity's activities after January 1, 1941, constituted the doing of an insurance business, no liability or liquidation problems were created, and the business remained that of an investment company, which has been carried on for nearly 30 years. "Where a corporation is engaged in two or more distinctive lines of business, one of which would subject it to the Bankruptcy Law, while the other would not, the decision of its amenability to the involuntary Bankruptcy Act will depend on the nature and character of that business which, under all the facts and circumstances, constitutes its chief or principal pursuit. *Cate v. Connell*, * * * 173 F. 445 * * * *In re Interstate Paving Co.* (D. C.) 171 F. 604." *In re Wisconsin Co-operative Milk Pool*, 35 F. Supp. 787, 789-90 (E. D. Wis.). See also *In re Dairy Marketing Association of Ft. Wayne, Inc.*, 8 F. (2d) 626 (D. Ind.). The principle would seem to apply equally to voluntary bankruptcy.

judicial reorganization of the debtor corporation which had been in progress for some years, *supra*, pp. 10-12. Hence the classification of the debtor's business should be determined by the nature of the business before the changes. Cf. *Capital Endowment Co. v. Kroeger*, 86 F. (2d) 976 (C. C. A. 6). The fact that it ceased to sell its investment contracts before the institution of these proceedings is immaterial. *In re Peoria Life Insurance Company*, 75 F. (2d) 777 (C. C. A. 7); *In re National Surety Co.*, 7 F. Supp. 959 (N. D. N. Y.); *In re Union Guarantee & Mortgage Co.*, 75 F. (2d) 984 (C. C. A. 2); *In re New York Title and Mortgage Company*, 9 F. Supp. 319 (N. D. N. Y.).

The court below, however, held (R. 248) that in any event Fidelity's status for purposes of the Bankruptcy Act was to be determined not by its predominant business activity (pursuant to which it had acquired all its assets and incurred all its substantial liabilities); but by its charter powers and its classification under state law. Accordingly, despite the fact, as we have noted, that Fidelity's status as an insurance company was purely formal, that it was acquired only after Fidelity had virtually gone out of business, and that there was no significant exercise of insurance powers, the court below held that Fidelity was ineligible for bankruptcy under Section 4 of the Bankruptcy Act.¹⁹

¹⁹ This decision may have consequences going beyond the exclusion of this particular corporation from the Bankruptcy Act. Section 28 of the Investment Company Act was expressly enacted to regulate Fidelity and one or two similar face amount certificate companies, in reliance on the report of the Commission dealing with such companies by name (*supra*, note 4). See S. Rep. No. 1775, 76th Cong., 3d Sess., pp. 6, 10-11, 19-20; Hearings before a subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess., on S. 3580, Part 1, pp. 301-2, 134. A face amount certificate company is defined in Section 4 (1) of the Act as "an investment company which is engaged or proposes to engage in the business of issuing face-amount certificates of installment type, or which has been engaged in such business and has any such certificate outstanding." An insurance company is defined in Section 2 (a) (17) of the same Act as "a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance * * * and which is

We submit that this conclusion overlooks the underlying basis of the exclusions of Section 4. In that section, Congress excluded from the Bankruptcy Act as voluntary bankrupts municipal, railroad, insurance, and banking corporations, and building and loan associations. The essential feature common to these categories of enterprises was recognized by Congress to rest in their "responsibilities to the public" flowing from their performance of a public service. See H. Rep. No. 511, 61st Cong., 2d sess. (1910), p. 5.

If, as we submit, the touchstone is the public interest in maintaining these enterprises as going public services, eligibility for the benefits of the Act as a voluntary bankrupt under Section 4 should rest not upon accidental or formal classification of the debtor but upon the actual nature of its activities. *In re Columbia Ry., Gas & Electric Co.*, 24 F.

subject to supervision by the insurance commissioner * * * of a State * * *". Under Section 3 (b) (3) of that Act no insurance company is an investment company. Thus the decision of the court below that Fidelity is an insurance company, to the extent that it is influential on the construction of these provisions of the Investment Company Act of 1940, might leave Fidelity immune both from the Bankruptcy Act and from regulation under the Investment Company Act.

Moreover, Section 29 (a) of the Investment Company Act amends Section 67 of the Bankruptcy Act by adding provisions applicable to the bankruptcy of face amount certificate companies. The effect of the decision below is to leave Section 29 (a) with no sphere of operation as applied to face amount certificate companies which choose to resort to the devices adopted by Fidelity.

(2d) 828 (E. D. S. C.), affirmed, 27 F. (2d) 52 (C. C. A. 4). That the debtor may have acquired an insurance charter under state law cannot be controlling unless the powers so granted were exercised to such an extent that the public interest requires their continuance. The character of the activity carried on is the basic criterion; whether a corporation "can" be adjudged a bankrupt depends upon what it actually does, not what it is empowered to do." *In re Kingston Realty Co.*, 160 Fed. 445, 446 (C. C. A. 2); *In re Roumanian Workers Educational Association*, 108 F. (2d) 782 (C. C. A. 6); cf. *In re Wisconsin Co-operative Milk Pool*, 119 F. (2d) 999 (C. C. A. 7); *Cate v. Connell*, 173 Fed. 445 (C. C. A. 1).²⁰ And plainly, under this test,

²⁰ See also *In re Supreme Lodge of the Masons Annuity*, 286 Fed. 180, 184 (N. D. Ga.); *In re Dairy Marketing Association of Ft. Wayne, Inc.*, 8 F. (2d) 626 (D. Ind.). Commentators similarly take the view that the essential test is the character of the corporation's activity. Finletter, *Law of Bankruptcy Reorganization* (1939) 107; Note (1941) 18 N. Y. U. L. Q. 399, 402.

The court below, however, referred to other cases as supporting its rule of state classification (see R. 249-253). These cases contain statements that charter power and state classification constitute the controlling consideration. E. g., *In re Union Guarantee & Mortgage Co.*, 75 F. (2d) 984, 985 (C. C. A. 2); *Woolsey v. Security Trust Co.*, 74 F. (2d) 334, 335, 337 (C. C. A. 5); *Security B. & L. Assn. v. Sparlock*, 65 F. (2d) 768, 771 (C. C. A. 9); *Kansas v. Hayes*, 62 F. (2d) 597, 599-600 (C. C. A. 10); *Clemons v. Liberty Savings & Real Estate Corp.*, 61 F. (2d) 448, 450 (C. C. A. 5). It is to be noted, however, that in most of the cases the decisions were equally consistent with the view that business actually done should be the controlling factor. *Woolsey v. Security*

Fidelity was not an insurance company ineligible to become a voluntary bankrupt.

II

THE PETITION WAS FILED IN GOOD FAITH

As a separate ground of its decision, the court below held that Fidelity did not file its petition for reorganization under Chapter X in good faith (R. 257-263). While the court concluded that "there appears to be no reasonable hope of a reorganization of the business as a going concern, but only the immediate need of a liquidation of the company's assets for the benefit of the contract holders" (R. 259), we do not understand that this was a holding that it is unreasonable to expect that a plan can be effected so that good faith is lacking within the meaning of Section 146 (3) of the Bankruptcy Act (*supra*, p. 4). Rather, the court below appears to have held only that for the purposes

Trust Co., supra; Security B. & L. Assn. v. Spurlock, supra; Kansas v. Hayes, supra; Clemons v. Liberty Savings & Real Estate Corp., supra. Charter power and state classification have in fact been determinative in only two situations: (1) where *ultra vires* acts are relied on as affecting amenability to bankruptcy, *Clemons v. Liberty Savings & Real Estate Corp.*, 61 F. (2d) 448 (C. C. A. 5); *Gamble v. Daniel*, 39 F. (2d) 447 (C. C. A. 8); *In re H. J. Quimby Freight Forwarding Co.*, 121 Fed. 139 (D. Mass.); (2) where it is debatable whether the business carried on falls within any of the categories excluded by the Act, compare *In re Union Guarantee & Mortgage Co.*, 75 F. (2d) 984 (C. C. A. 2), with *In re Prudence Co.*, 79 F. (2d) 77 (C. C. A. 2); and see *In re Grand Lodge A. O. U. W.*, 232 Fed. 199 (N. D. Calif.).

of Section 146 (4) the respective merits of pending state procedures and the bankruptcy procedure must be tested in the light of the fact that liquidation, not reorganization as a going concern, was the realistic probability. Nevertheless, since the question of good faith under Section 146 (3) was argued below, we shall examine that question as well as the issue of good faith arising under Section 146 (4) in the course of the following argument. We submit that whether Fidelity is to be reorganized or whether it is to be liquidated, the creditors' interests will not be best subserved by the state proceedings and that Chapter X affords a more adequate machinery.

A. The interests of Fidelity's creditors will not be best subserved by the pending local proceedings

The court below held that the pending proceedings in various states are superior to the proceedings available under Chapter X for purposes of liquidation, and that, therefore, the instant petition lacked good faith since the local proceedings would best subserve the interests of Fidelity's creditors. None of the statutes governing those proceedings (see Appendix D, Appendices, pp. 10-74) appears to vest title in state liquidators as statutory successors, and, in general, the state receivers would have jurisdiction over only the assets in the states of their respective appointment, and would have no power to bring suit to secure assets and surplus

deposits in other states (R. 1206). *Booth v. Clark*, 17 How. 321, 339; *Great Western Mining Co. v. Harris*, 198 U. S. 561; *Lion Bonding Co. v. Karatz*, 262 U. S. 77. Cf. *Clark v. Williard*, 292 U. S. 112. Nevertheless, the court below concluded that continuation of the state proceedings would best subserve the interests of the creditors because (1) it did not clearly appear that there would be any surplus in any state except West Virginia; (2) the manner of distribution of funds in each state must be determined in any event according to the state law; and (3) creditors could as well file claims for the West Virginia surplus in a West Virginia state court as in the federal court for West Virginia having jurisdiction of the instant proceedings.

The issue upon this branch of the case is, ultimately, whether there should be separate liquidations and distributions by the several local receivers, or whether there should be a centralized administration which offers a forum for scrutiny of the history and management of this enterprise and for the resolution of the complex problems involved, and provides a machinery for a more effective and precise distribution. In reaching its conclusion that the local proceedings best subserve the interests of Fidelity's creditors, the court below failed to give due weight to a number of factors which establish the superiority of Chapter X proceedings, which should be controlling, and which led the District Court to sustain the Debtor's petition (R. 194-199).

1. *The necessity for impartial investigation.*—The history of Fidelity and the course of its efforts to reorganize establish that it is peculiarly salutary in this case to utilize the provisions of Chapter X, which makes administrative assistance available to the court (Sec. 208 of the Bankruptcy Act, 11 U. S. C. § 608) and which provides for impartial investigation into the acts of the management by an independent trustee with independent counsel looking to recoveries for the benefit of the estate, and ultimately of the creditors. See Secs. 156-158, 167; 11 U. S. C. §§ 556-558, 567.

There are strong indications in the record that extravagance and other serious mismanagement mark Fidelity's history (R. 440-473): Both the district court and the court below found "unsoundness in Debtor's methods of management" and referred to its "extravagant sales and promotion expenses; useless expenditures for lavish offices * * *; overexpansion, * * * poor judgment in selection of the personnel * * *;" (R. 195, 258-259). Auditor Sims, in the course of his testimony, stated that there was "stealing" of the company's assets (R. 441, 459), that the officers were guilty of "reckless squandering and spending" (R. 442), of "kiting salaries, making advances to salesmen in large sums, which they had not earned" (R. 472), that the officers of Fidelity were "incorrigibles" (R. 474), that he had called them "thieves and a bunch of brigands" (R. 476), and that "this is the roughest bunch I ever got

hold of. You can't save them from their own folly, in wasting their own money" (R. 477). Further, Fidelity consented, upon complaint filed by the Commission in December 1938, to a final judgment enjoining it, its officers, directors, and employees, from violations of the fraud provisions of the Securities Act of 1933.²¹ And in the courts below, bitter recriminations and charges of personal self-seeking and of improper activities have characterized the course of this proceeding (see, e. g., R. 69-72, 472-473).

Whatever the validity of these charges, involving the *bona fides* and legality of the actions of Fidelity's management, their existence establishes the desirability of investigation of possible civil actions on behalf of Fidelity's estate against the officers, directors, and perhaps others. The investigatory processes and impartial trustee provided by Chapter X are particularly appropriate to fulfill this function as against the local procedures in this case, for the record indicates that the conflicting interests in the latter proceedings are such as to lack assurance of the thorough exploration which appears to be demanded. Problems of venue and jurisdiction would seem to be major, if not insuperable, obstacles to civil suits

²¹ The text of the complaint, accompanying affidavits, and the final judgment are set out in the Report, *supra*, note 4, at pp. 197 ff. In Appendix C, Appendices pp. 6-9, we summarize some of the allegations of the complaint and affidavits relating to the financial practices of this company.

at the instance of the state officials in every state but West Virginia. In that state, the receivership proceedings were instituted by respondent Sims, after friendly consultation with, and with the consent of, Fidelity's officials (R. 410-412, 458, 603, 1187; Ex. 94). Although the firm of Koontz & Koontz, Fidelity's regular counsel (R. 574, 1136), appeared for Fidelity in the West Virginia proceeding instituted by Sims (R. 604, 690); Koontz & Koontz thereafter became, with Sims' acquiescence, the attorneys for the West Virginia receivers (R. 574). Indeed, one of the receivers, Ross Thomas, is an associate of the firm of Koontz & Koontz (R. 574, 1135), although Arthur Koontz, senior member of the firm, had long been a director of Fidelity, is one of the officers under indictment (R. 1167), and might be subject to liability if there is substance to these charges.

We submit that the interlocking relationships among the officials of Fidelity and the receivers and their counsel create divided loyalties which establish that the West Virginia receivership does not promise as adequate investigation and prosecution of causes of action against Fidelity's management as may be expected from the disinterested trustee appointed under Section 156 of the Bankruptcy Act, represented by a disinterested attorney appointed under Section 157, and assisted by a disinterested administrative agency under Section 208. The superior possibilities af-

fording under Chapter X for pursuing, on behalf of Fidelity's estate and the creditors, the remedies which appear *prima facie* to be appropriate alone warrant the conclusion that the Chapter X proceedings will subserve the creditors' interests better than the state proceedings, and justify the finding of the district court (R. 198) that it is not "reasonable to suppose" in the "light of all the facts and circumstances in connection with the state court receivership" that the directors' liabilities will be "diligently sought out and pursued," and that therefore the "best interests of creditors" would not be subserved in the prior proceedings. Since these findings were plainly supported, and since the persons involved were before the District Court as witnesses and participants, the findings should not have been rejected by the court below.

2. *The necessity for a single administration to settle problems of marshalling assets and of distribution.* The instant case presents complex and difficult problems of the respective rights of competing creditors. In contrast to the situation which obtained in *Marine Harbor Properties, Inc. v. Manufacturer's Trust Co.*, No. 24, this Term, decided November 9, 1942, there is here not a single class of local creditors with identical interests, but many classes of creditors with competing interests in the funds.²² Fidelity has outstanding six dif-

²² Respondent Sims alleged that if the so-called "trust fund" theory of Fidelity's assets be recognized, there are 117 classes of creditors (R. 75).

ferent series of contracts which were sold in 29 states and the District of Columbia (R. 179, 241). There are 88,000 contract holders residing in every state and in foreign countries (R. 242), and the net cash liability to each of these holders averages less than \$273.²³

The nature of these different claims presents a complex problem of creditors' rights involving the marshalling of assets and the determination of a number of doubtful legal issues. In the light of the great number of scattered creditors with these small claims, it appears plain that their interests will be best subserved by a single unified administration in which all the groups can settle the problems of marshalling, and distribute assets in an equitable and orderly manner, rather than by piecemeal, hasty, and inconsistent administration by a dozen sets of state officials and courts.

(a) *The problem of marshalling assets.* Preliminary to the problems of an equitable distribution there is the complex task of disentangling the assets of each of the several series in order that they may be properly and effectively marshalled. As we have described above (p. 6), the later series of contracts required Fidelity to segregate for the benefit of contract holders of the particular series the money paid by the holders of that series and the assets acquired by the use of such money. Although Fidelity maintained such segregation on

²³ The outstanding contracts represent an aggregate net cash liability of \$23,475,668.67 (R. 242).

its books, assets were transferred from series to series in order to increase the book value of Fidelity's portfolio. Similarly, money was transferred from series to series, when needed to pay contract holders, for the purpose of avoiding the realization of loss on assets held by the borrowing series. These transfers were made on open book account. No series for which cash was borrowed has sufficient assets to pay both its contract holders and the lending series. Accordingly, before distribution can be made to Fidelity's contract holders, the accounts of the various funds *inter sese* must be settled. Unless this is done, assets which Fidelity was contractually obligated to segregate for one group of contract holders will be appropriated on behalf of another group of holders.²⁴

The respondent state representatives take the position, in general, that the several states may apply their respective deposits among all of the contract holders secured thereby, without regard to the contract series to which the liabilities pertain or to which the deposited assets belong. But we believe that there is a problem whether states may retain securities accepted in disregard of

²⁴ Long before the present proceeding, Fidelity's officers and counsel indicated their own belief that the assets in the several contract series funds were in the nature of "trust funds" which had to be kept segregated and could not be used to meet the liabilities of other funds. See the excerpts from testimony and opinions of counsel in one of the affidavits in the injunction suit brought by this Commission, reprinted in Report, *supra*, note 4, at 225-228.

knowledge or notice that the assets deposited belonged to particular series funds and were deposited to secure liabilities of other series (*supra*, p. 9). Should this issue be decided adversely to the states in question, these states might not be able to retain their entire deposits even though some of their local security holders remained unpaid. Thus, these problems of marshalling assets are not dissipated, as the court below assumed (R. 261) merely by the fact that there would be little or nothing for nonresident creditors if the local deposits were distributed to local creditors without regard to series. The problems involved should be faced, not evaded by hasty distributions.²⁵

We submit that the several prior proceedings, some judicial and some administrative, do not provide suitable *fora* for marshalling assets or for an accounting between funds. No state has power itself to marshall the corporation's aggregate assets, and determine the nation-wide liabilities of the several funds. It is obviously not feasible to do so by joint action of the several sets of state officials, nor likely that they would cooperate in

²⁵ The states have indicated frankly their intention to distribute the deposited assets among local contract holders without regard to fund segregation requirements (brief filed in court below on behalf of L. H. Brooks, *et al.*, pp. 13-14; brief filed in court below on behalf of Banking Commission of Wisconsin, *et al.*, p. 60). Such a facile disposition of the assets would leave unsolved the problems of interfund accountings and marshalling of assets by series.

view of their rejection of the "fund theory" of marshalling the assets (reply brief filed below on behalf of West Virginia, p. 41; brief in opposition filed by L. H. Brooks, *et al.*, p. 23). In contrast, the bankruptcy procedure, providing a single administration with all groups and all participants before it, and with the assets under its control, is better suited for the task of restoring the assets to the proper funds in accordance with Fidelity's contractual obligations.

(b) *The problems of distribution.*—Similarly, the difficult problems of conflicting creditors' rights can best be settled in a single administration.

There is a conflict of interests not only among the several series of contract holders (*supra*, pp. ~~32~~³⁵–38) but also between the resident and non-resident contract holders in respect of deposits in each state. These conflicts give rise to the following difficult questions which must be settled before there can be an equitable distribution:

(i) It must first be determined whether the state deposits are solely for the benefit of local residents and not for the benefit of all contract holders. Under the laws of some of the states, the answer to this question is by no means clear,²⁶ e. g., the

²⁶ This question seems to turn largely on the language of the local statutes (Appendix D, Appendices, pp. 10–74). The law has been stated as follows (23 Am. Jur. 468):

Where, however, there is no expression in the statute which limits the benefit of the deposit to resident shareholders and creditors, nonresident creditors of such an insolvent company may be held entitled to

statutes of Kentucky, Missouri, Tennessee, and Virginia, Appendix D. In the domiciliary state of West Virginia, where the deposit is clearly intended to secure all creditors (R. 436-437, 1151) (Appendix D, Appendices, pp. 63-65), it must be determined whether West Virginia creditors have a preferential interest. We understand that the West Virginia authorities contend that such a preference exists, but we find no justification therefor on the face of the statutes.

(ii) If the local deposit is for the benefit of local contract holders, it must be determined whether the critical date of residence is (1) at the time of the sale of the particular contract; or (2) at the time of the deposit, or (3) the present time. Since the local deposits are conditions precedent

share in the distribution equally with resident creditors.

In the following cases resident creditors were denied preferential recourse to local deposits. *Davis v. Life Assn. of America*, 11 Fed. 782 (S. D. Ala.); *Holloway v. Federal Reserve Life Ins. Co.*, 21 F. Supp. 516 (W. D. Mo.); *Parsons v. Charter Oak Life Ins. Co.*, 31 Fed. 305 (S. D. Iowa); *American Bonding and Casualty Co. v. Chicago Bonding & Insurance Co.*, 251 Ill. App. 549 (1929); *Morrell v. Colonial Security Co.*, 101 Tex. 309, 107 S. W. 524 (1908). See also *Taylor v. Life Assn. of America*, 13 Fed. 493 (W. D. Tenn.). Cf. *People v. Granite State Provident Assn.*, 41 App. Div. 257, 58 N. Y. Supp. 510 (1899). In *Irwin v. Granite State Provident Assn.*, 38 Atl. 680 (Chancery Court of N. J. 1897), the court held that the statute dedicated the deposit to payment of local creditors but only to the extent of the proportionate dividend received by all other creditors as computed by the domiciliary receiver.

to the privilege of selling securities within the states, it is arguable that they are for the benefit of local *purchasers*, and some of the statutes require deposits to secure contracts sold in the state, rather than resident holders. But Fidelity for the sake of uniformity computed its periodic deposits in the various states according to the residences, at the time of the deposits, of its contract holders, as shown by the books, (R. 757-758).

(iii) In addition, it must be determined whether the measure of the claims is (1) the cash value of the contracts, which is the only amount the contract holders could demand prior to the maturity of their contracts if Fidelity were a going concern, and the contractual minimum of the various contract funds and of most of the state deposits; or (2) the actuarial reserve liabilities under the contracts, which would be the amounts that ought to be on hand in order to pay the contracts according to their terms; or (3) the amounts which the contract holders actually paid in, which is the only measure which would give recognition to new contracts;²⁷ or (4) some

²⁷ It has been held, in the case of a contract somewhat similar to Fidelity's, that the creditor is entitled to recover the amount he has paid, with interest. *In re Bankers Mortgage Co. of Topeka, Kans.*, 83 F. (2d) 50 (C. C. A. 19). Cf. *Lovell v. St. Louis Mutual Life Insurance Co.*, 111 U. S. 264. In a case involving a fully paid endowment policy in an insolvent insurance company in liquidation, it was assumed that the policy holder's claim was the maturity amount discounted to present value. *Carr v. Hamilton*, 129 U. S. 252, 257-258.

other amount. The measure of damages not only determines the amount due to any individual but affects the amount of deficiencies to be satisfied elsewhere if possible, and thus affects as well the whole inter-relationship of resident and nonresident creditors in each state. In Wisconsin, for example, it appears that there may be a surplus over deposits if cash surrender value is the measure (Appendix A, Appendices, p. 2). There, as elsewhere, however, there are contract holders whose contracts have not yet achieved cash surrender value.²⁸ Thus, even were it assumed that residents are entitled to the local deposits, in the Wisconsin situation certain resident contract holders might receive nothing, and nonresidents may still be partially satisfied out of the Wisconsin deposit.

The presence of these questions, each with an impact upon the others, and all bearing upon the ultimate problem of making an equitable distribution to the persons legally entitled to satisfaction of claims and in the legally correct amount, underscores the inadequacy of the existing state proceedings. The course of this case establishes that there is little inclination among the state officials to litigate their conflicting rights *inter sese*, or to

²⁸ The contracts do not have a cash surrender value until after a substantial number of payments have been made. In the typical case, at least nine monthly payments were required (*supra*, p. 6; Ex. 1-5).

withhold distribution until contract holders can litigate the questions.

The state officials who appear as respondents in opposition to the bankruptcy proceedings are those representing states which are in a relatively good position in respect of their own deposits. These, therefore, are the states with an interest in keeping deposits for the benefit of local creditors, and with little incentive to establish possible rights of their own residents in the deposits held by other states (Appendix A, Appendices, pp. 1-2). The frank purpose of these depositories is to avoid litigation of these questions and to make immediate distribution (*supra*, note 27).

But such a course would not only leave unsettled the conflicting rights among the states but, as a practical matter, would be likely altogether to deprive the contract holders from states with little or no deposited security of a forum in which they could litigate the questions presented. The intention, if realized, of the state representatives to proceed at once to distribute the assets without regard to the inherent problems might well result in the disposition of the assets before the contract holders even have time to begin the litigation of their rights. But even assuming that the contract holders can reach the courts while the assets are intact, other grave obstacles block the effective determination of the conflicting rights. The contract holders from

states without deposits and states with inadequate deposits must take the burden of obtaining the litigation of these questions in each of the states with sizable deposits. The geographical difficulties, the multiplicity of suits in different *fora*, the small size of the claim of each separate contract holder (*supra*, p. 3⁵), and the multitude of possible conflicts of interests among contract-holders which impede formation of large groups, strongly indicate that those who may be entitled to satisfaction of their claims, and who, at the least, are entitled to litigate these questions, will be eliminated by default unless an orderly central administration is provided. The issue on this branch of the case, is not, as stated by some of respondents,²⁹ whether the contract holders "would rather get 80% of their claims now than 85 or 90% ten years from now," but rather whether the assets are to be immediately distributed to those who may not be entitled to them, or whether the distribution is to be deliberate enough to permit a determination as to who is entitled to what amounts.

3. *The necessity of orderly procedure to liquidate the assets.*—A third separate factor establishing the desirability of Chapter X proceedings stems from the nature of the task of liquidation which would be presented. Fidelity's assets are such that

²⁹ Reply in Opposition to Memorandum of Securities and Exchange Commission, filed on behalf of respondents Brooks, Leake, Goldberg, and Godfrey, p. 32.

there is serious peril to a maximum realization upon them if each state depository separately proceeds to immediate liquidation without regard to the over-all effect of simultaneous sale. The situation is plainly one which requires well-timed and skillful liquidation (R. 799-800), and the district court so found (R. 196-197). The trustee's report under Section 157 of the Bankruptcy Act (Report, pp. 29-30, see *supra*, note 6) shows that a substantial part of Fidelity's portfolio falls below the standard of high-grade and readily marketable securities. The analysis of Fidelity's portfolio in terms of ratings used by standard investment services shows:

Rating	Amount, book value	Percent, book value
AAA-A	\$6,200,000	29
BBB-B	8,500,000	39
CCC-DD	2,355,000	11
Not rated	4,484,000	21
Total	\$21,539,000	100

* High grade.

* Good, medium, uncertain.

* Default threatened or existing.

Thus prime securities comprise less than one-third of the debtor's portfolio; medium and low grade issues, some of which are in default, constitute half of the total; and more than one-fifth are not rated. In addition the estate has a large office building in Wheeling, valued at \$450,000 (R. 612), and other real estate (R. 612-614, 619).

With respect to certain securities, blocks held by the estate are so large and the market so thin (R. 799-800, 196-197) that throwing the securities on the market might greatly depress the price. For a maximum realization upon these assets, the portfolio must be liquidated in an orderly fashion unhampered by pressure for immediate liquidation and by competition by various state depositaries to exhaust the available demand. The process requires time and skill, and most of all freedom to exercise discretion as to the timing of sales and the selection of issues and quantities to be sold. After the decision below, the states attempted to meet the clear need by informal agreement for cooperative action of the officials involved (R. 279, 282). But the Chapter X proceeding is obviously superior to the several separate state proceedings for this purpose.

Summary.—We submit, therefore, that in the light of the facts indicating the need for independent trustees and an independent investigation, of the facts showing the desirability of an orderly marshalling and distribution, and of the facts establishing the need for a central administration, the District Court properly concluded that the interests of the creditors will not be best subserved by a continuation of the pending state proceedings. That many of the questions which must be litigated in the bankruptcy court may primarily be questions of state law should not affect this conclusion. Federal courts are, of course, frequently called

upon to determine questions of state law, especially in bankruptcy proceedings. *Erie R. Co. v. Tompkins*, 304 U. S. 64; *Fischer v. American United Life Ins. Co.*, 314 U. S. 549. See *In re Chicago & Northwestern Ry. Co.*, 127 F. (2d) 1001 (C. C. A. 7); cf. *Burgess v. Seligman*, 107 U. S. 20. In this case, where the issues involved present a conflict between resident creditors and out-of-state creditors, it is particularly appropriate that the federal courts should resolve the conflict.

B. *It is not unreasonable to expect that a plan of reorganization may be effected*

That, as the court below assumed, Fidelity is insolvent and the possibilities of its rehabilitation as a going concern may be negligible does not establish the unreasonableness of an expectation that a plan of reorganization may be effected within the meaning of Section 146 (3) of the Act (*supra*, p. 4).³⁰ On this issue, Fidelity's insolvency is not material, since Chapter X is expressly applicable to insolvent corporations. See Sections 130 (1), 179 (11) U. S. C. §§ 530 (1), 579); *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106, 131; *In re Central Funding Corporation*, 75 F. (2d) 256

³⁰ No question would be raised, of course, if Fidelity can in fact be reorganized as a going concern. Some of the respondents have stated that when the petition was filed Fidelity could have been reorganized on a going concern basis (R. 486; see reply brief filed below on behalf of West Virginia, pp. 34-36). If this be so, there clearly is no issue of good faith under Section 146 (3) and our discussion in the text becomes irrelevant.

(C. C. A. 2); *In re Julius Rochrs Co.*, 115 F. (2d) 723 (C. C. A. 3).

Nor would resort to Chapter X be foreclosed even on the assumption that the debtor may not be susceptible of reorganization on a going-concern basis. Other methods of disposition of assets would satisfy the requirements of a reorganization plan. And even if we accept the respondents' current contention that only liquidation is possible—a contention inconsistent with their earlier position (*supra*, note 30)—such a result is not fatal to good faith under Section 146 (3). For frequently a reorganization is appropriate to provide the machinery for liquidation and to take the debtor out of court. Liquidation cannot proceed indefinitely under the aegis of a court; yet the assets may be, as they are here (*supra*, pp. 42-43), such as to require a deliberate and orderly liquidation without pressure. Cf. *In the Matter of Reynolds Investing Co.*, 6 S. E. C. 639 (1940). In contrast to ordinary bankruptcy or equity proceedings, Chapter X provides the means for creating a new corporation or other device charged with the duty of liquidating the assets as slowly as necessary and as expeditiously as is possible under the circumstances. This type of plan is a "plan of reorganization" under the Act. Cf. *In re Porto Rican American Tobacco Company*, 112 F. (2d) 655 (C. C. A. 2); *In re Central Funding Corporation*, 75 F. (2d) 256 (C. C. A. 2); *In re Mortgage Securities Corporation*, 75 F. (2d) 261 (C. C. A. 2); *R. L. Witters*

Associates v. Ebsary Gypsum Co., Inc., 93 F. (2d) 746 (C. C. A. 5); *Continental Insurance Company v. Louisiana Oil Refining Corporation*, 89 F. (2d) 333 (C. C. A. 5). And such a plan may be the means of compromising the difficult problems of distribution pointed out above. Cf. *Consolidated Rock Products Co. v. Du Bois*, 312 U. S. 510.

We submit, therefore, that if other methods of reorganization be impracticable, then liquidation in an orderly fashion becomes important in this situation; that provision of the machinery for such liquidation constitutes a plan of reorganization within the meaning of Section 216 of the Bankruptcy Act (11 U. S. C. § 616); and that, accordingly, good faith is not lacking within the meaning of Section 146 (3).

CONCLUSION

For the foregoing reasons, the decision of the court below should be reversed.

Respectfully submitted.

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